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In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 183

WALTER A. SHEAFFER, II, AND JOHN D. SHEAFFER, Executors of the Estate of Craig R. Sheaffer, Deceased, and VIRGINIA D. SHEAFFER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. 1a-13a) is reported at 37 T.C. 99. The opinion of the court of appeals (Pet. 14a-23a) is reported at 313 F.2d 738.

JURISDICTION

The judgment of the court of appeals was entered on February 13, 1963. (Pet. 24a.) A petition for re-

hearing was denied on March 6, 1963. (Pet. 2.) The petition for a writ of certiorari was filed on June 3, 1963. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

Whether the grantor is taxable, under § 677 of the Internal Revenue Code of 1954, on the income of a trust used to pay the gift taxes on the transfer to the trust or to repay amounts borrowed by the trust earlier in the same year to pay the gift taxes.

STATUTES AND REGULATIONS INVOLVED

Sections 1000(a), 1008(a), and 1009 of the Internal Revenue Code of 1939; § 677(a) of the Internal Revenue Code of 1954; §§ 86.1 and 86.3 of Treasury Regulations 108 (1939 Code); and § 1.677(a)-1 of Treasury Regulations on Income Tax (1954 Code) are set forth in relevant part in the Appendix, pp. 9-11, *infra*.

STATEMENT

On February 2, 1954, petitioner Virginia D. Sheaffer [1] transferred stock valued at $1,715,000 in trust

[1] Craig R. Sheaffer, her husband, consented to have the gift treated as made one-half by him for gift tax purposes (see § 1000(f), Internal Revenue Code of 1939) and also filed joint income tax returns with his wife for the years involved. It is only for that reason that the executors of his estate are parties, and for simplicity we will refer to Virginia as the sole grantor and taxpayer.

for her children. The trust agreement with the corporate trustee provided that:

> The trustee agrees that, to the full extent of the value of the corpus of the trust estate and the income therefrom, it will assume and pay all federal and state gift taxes * * * which shall * * * become due from any one by reason of the transfer [of the stock to it] * * *. The trustee is authorized and agrees to obtain a loan in an amount sufficient to pay all such taxes and to pledge or otherwise to apply such part or all of the corpus and income of the trust estate, and to take such other action, as shall be required or deemed advisable by the trustee in order to secure the loan. The trustee agrees to apply the proceeds of such loan in payment of such taxes.

The gift tax due on the transfer, computed on the net value of the gift after deducting the trustee's assumed obligation to pay the gift tax, was $327,307.[2] The trustee paid the tax on March 14, 1955, one day prior to the due date of the returns. The funds used to pay the tax consisted of $188,607 of accumulated trust income plus $138,700 borrowed by the trustee on the security of the trust assets (Pet. 2a-5a).

The trust received dividends on the contributed stock totalling $140,000 in 1954 and $115,500 in

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[2] In years subsequent to those involved here, the Commissioner determined that the value of the shares was somewhat higher than reported ($1,845,701) and determined a deficiency that was duly paid by the trust (Pet. 6a), but that does not affect the issues presented here.

1955 (Pet. 6a-7a). The Commissioner held the dividends taxable to the grantor under § 677 of the Internal Revenue Code of 1954, on the ground that the trust income had been used for her benefit by paying the gift taxes for which she was primarily liable. The Tax Court upheld the deficiencies (Pet. 1a-13a), and the court of appeals affirmed its decision (Pet. 14a-23a).

ARGUMENT

1. Taxpayer does not deny that she would be taxable on the income of the trust if, instead of directing payment of the gift taxes, the trust instrument had simply directed the trustee to pay such income directly to her on March 14, 1955. Her sole argument is that the trust's payment of the gift taxes was not equivalent to a cash distribution to her. The question, therefore, is whether a donee's payment, pursuant to a contract with the donor, of the gift tax on the gift is a "receipt" by the donor of the amount so paid.

The gift tax is a tax on the donor's transfer, not the donee's receipt, of property. Not only is the tax measured by the donor's total gifts (to determine exemptions and rates), but the Code expressly provides that the gift tax "shall be paid by the donor on or before" March 15 (§ 1008(a)). The donee has no duty to pay the tax on the due date and becomes "personally liable" only "If the tax is not paid when due" (§ 1009)—in short, only if the donor is in default. The regulations thus correctly conclude that the gift tax "is a primary and personal liability

of the donor" and is "an excise upon his act of making the transfer." Treas. Regs. 108, § 86.3. See *Mississippi Valley Trust Co.* v. *Commissioner*, 147 F. 2d 186 (C.A. 8); *Fletcher Trust Co.* v. *Commissioner*, 141 F. 2d 36 (C.A. 7), certiorari denied, 323 U.S. 711.

The tax being the primary obligation of the donor, it follows from settled principles that the bargained-for contractual undertaking by another to pay it results in a constructive receipt by the donor of the amount paid. *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716 (employer's payment of employee's income tax), holds at least that much. See also *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (creditor's forgiveness of indebtedness); *Douglas* v. *Willcuts*, 296 U.S. 1 (trust's satisfaction of grantor's support obligations); *Helvering* v. *Blumenthal*, 296 U.S. 552 (trust's payment of grantor's debt).

Taxpayer argues however, that that doctrine is subject to two limitations which render it inapplicable here. First, she contends that the payment of a liability by an obligor does not give rise to a taxable receipt by a co-obligor, even though the latter may be primarily liable (Pet. 12-13). The only case she cites which even arguably supports that proposition[3]

[3] Two other cases cited by petitioner, *Tucker* v. *Commissioner*, 226 F. 2d 177 (C.A. 8), and *Commissioner* v. *Hopkinson*, 126 F. 2d 406 (C.A. 2), are wholly inapposite. In *Tucker*, the payments sought to be imputed to the taxpayer as a constructive dividend did not discharge any legal obligation of his, and whatever benefit, if any, they may have conferred upon him was an entirely incidental aspect of a transaction whose sole purpose was to benefit the corpora-

is a prior decision of the Eighth Circuit itself, *Ruben* v. *Commissioner*, 97 F. 2d 926)—a case which the same court did not deem dispositive here (Pet. 17a) and which plainly cannot serve as the basis for a conflict.

Second, it is urged that the satisfaction of a taxpayer's legal obligation does not give him taxable income where the indebtedness was gratuitously incurred (Pet. 13-15). Whatever validity that proposition may have—and we concede it none—in the case of a truly gratuitous indebtedness, it has no application in the instant case. Here, the discharged obligation was not gratuitously assumed by the taxpayer but was a tax liability imposed upon her by law. Payment of such an obligation by a third person clearly gives rise to a taxable receipt. *Old Colony Trust Co.* v. *Commissioner*, *supra*.

2. Taxpayer is mistaken in asserting a conflict between the decision below and that of the Sixth Circuit in *Commissioner* v. *Morgan's Estate*, 316 F. 2d 238, affirming, *per curiam*, 37 T.C. 981 (Pet. 31a-38a). There certain stock was transferred in trust in 1955 with instructions that the trustees pay the gift tax, either by borrowing money or selling stock. In 1956, the trustees paid the gift tax with funds borrowed from a bank, and in 1957 and 1958

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tion. In *Hopkinson*, the Commissioner sought to tax the beneficiary of a trust on amounts paid by the trust as fees for legal services allegedly rendered the taxpayer. The court exonerated the taxpayer from liability expressly on the ground that the legal services in question had not been rendered to her but to the trustee, and hence the payment of the fees did not discharge any obligation of hers.

applied current trust income to the repayment of the loan. The Tax Court rejected the Commissioner's contention that the income so applied was taxable to the grantor in 1957 and 1958, and the Sixth Circuit affirmed on the Tax Court's findings and opinion. Since the Tax Court decided *Morgan* for the taxpayer less than four months after it decided *Sheaffer* for the Commissioner, and the two appellate decisions both affirmed the Tax Court, it would be surprising indeed to find them in conflict. The distinction drawn by the Tax Court in *Morgan* was this: whereas in *Sheaffer* trust income was used to discharge the settlor's gift tax liability in the taxable year in question, in *Morgan* that liability had been discharged, and the trustee's discretion to apply income for the settlor's benefit had been extinguished, before the controverted taxable years had even opened. This distinction apparently commended itself to the Sixth Circuit, which adopted the findings and opinion of the Tax Court, and also (though less clearly) to the court below, which observed (Pet. 22a) that it did not regard the Tax Court's *Morgan* decision "as controlling or dispositive of the issues presented herein."

Taxpayer points out that while most of the income sought to be taxed ($188,607.04) was applied directly to the payment of the gift tax, a portion of it ($66,892.96), like the income in *Morgan*, was received by the trust subsequent to the gift tax payment and used to repay the loan. The fact remains, however, that here, unlike in *Morgan*, (a) the taxpayers constructively received benefits from the trust in the very taxable year at issue (1955); and (b) all income

sought to be taxed, including the "after-received" income, had been received by the trust prior to the close of that same taxable year.

We note additionally that neither in this Court nor in the court of appeals did the taxpayer here advance the argument which carried the day for the taxpayer in *Morgan*; at no point has she suggested that the after-received income used to repay the loan should be treated differently from the accumulated income used to pay the gift tax itself. Her contention, rather, is that, regardless of the character (income or principal) of the trust funds used, the satisfaction of a settlor's gift tax liability by the donee trust does not give rise to a taxable receipt by the settlor. On that issue—the only one raised here—the Sixth and Eighth Circuits are plainly in agreement, both rejecting the taxpayers' position.

CONCLUSION

For the reasons stated, the petition should be denied.

Respectfully submitted,

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JULY 1963.

APPENDIX

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

SEC. 1000. IMPOSITION OF TAX.

(a) For the calendar year 1940 and each calendar year thereafter a tax, computed as provided in section 1001, shall be imposed upon the transfer during such calendar year by any individual, resident or nonresident, of property by gift. * * *.

SEC. 1008. PAYMENT OF TAX.

(a) *Time of Payment.*—The tax imposed by this chapter shall be paid by the donor on or before the 15th day of March following the close of the calendar year.

* * * * * *

SEC. 1009. LIEN FOR TAX.

The tax imposed by this chapter shall be a lien upon all gifts made during the calendar year, for ten years from the time the gifts are made. If the tax is not paid when due, the donee of any gift shall be personally liable for such tax to the extent of the value of such gift. * * *

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

SEC. 677. INCOME FOR BENEFIT OF GRANTOR.

(a) *General Rule.*—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the dis-

cretion of the grantor or a nonadverse party, or both, may be—

(1) distributed to the grantor;

(2) held or accumulated for future distribution to the grantor; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

* * * *

Treasury Regulations 108 (1939 Code):

SEC. 86.1 *Imposition of Tax.*—The statute imposes no tax upon property, but subjects to tax transfers of property by gift. * * *

* * * * *

SEC. 86.3 *Cessation of Donor's Dominion and Control.*—The tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability

of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

* * * *

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.677(a)-1 *Income for benefit of grantor; general rule.*

* * * * *

(d) Under section 677 a grantor is, in general, treated as owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor.

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U. S. GOVERNMENT PRINTING OFFICE 1965